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To	**:**	**The Chairman: South African Ports Regulator**
From	**:**	**The National Ports Consultative Committee**
Subject	**:**	**Proposals to Transnet National Ports Authority's Alteration of its Tariff Methodology and Pricing Strategy**

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PROPOSALS TO TRANSNET NATIONAL PORTS AUTHORITY'S ALTERATION OF ITS TARIFF METHODOLOGY AND PRICING STRATEGY

1. PURPOSE

The purpose of this memorandum is to submit proposals and recommendations from the National Ports Consultative Committee to the Ports Regulator of South Africa in response to the TNPA's proposed Tariff Methodology and Pricing Strategy.

2. BACKGROUND

Section 82(1) of the National Ports Act, Act 12 of 2005, empowers the Minister of Transport in the appointment of the National Ports Consultative Committee (NPCC). The function of the NPCC, amongst others, is to consider the National Ports Authority's (NPA) tariff applications, to comment on those, and to propose meaningful alterations where it is felt that it is necessary to do so.

Since the institution of the NPCC, the current Tariff Methodology and Pricing Strategy application is the first of its kind to be considered. Previous workshops were convened to discuss the TNPA's Tariff Application solely; As had been agreed on two previous occasions, an ad-hoc meeting of the NPCC was convened to discuss the Tariff Methodology and Pricing Strategy application, and to formulate and record any comments and proposed alterations for submission to the Ports Regulator of South Africa (PRSA).

3. NPCC TARIFF METHODOLOGY AND PRICING STRATEGY RESPONSE DISCUSSION

The meeting referred to above was convened in Durban on Tuesday and Wednesday 14-15 May 2013. Participants deliberated on the Tariff Methodology and Pricing Strategy as proposed by the TNPA. The meeting resolved that the NPCC's response to the PRSA should cover the following headings:

- Compliance with the National Ports Act, Port Regulations, Directives and the issues raised by the PRSA in the 2013/14 Record of Decision

- Content and Completeness: If there was sufficient information provided in the application, or not.
- To assess the basis for the proposed Tariff Methodology
- To comment on the Pricing Strategy proposed NPA
- To make Recommendations deemed necessary

3.1 Compliance with the Act, Regulations, Directives and the Records of Decision for 2013/14

3.1.1 Section 72(2) of the National Ports Act, indicates that the Authority must, prior to any substantial alteration of tariffs, consult with the NPCC. The NPA's proposed Tariff Methodology and Pricing Strategy Application was submitted to the PRSA on 1 August 2012. Same proposal was requested 3 years ago; This further required extensive interaction sessions between the TNPA and the PRSA to ensure that the final submission was in an acceptable form. The result was that the PRSA was able to publish the Application in January 2013 where after road shows were held during the first week of March 2013;

NPCC Comments:

It is not possible to determine the degree to which the TNPA complies with the 2013/14 ROD as same has not been issued;

NPCC's recommendations

The NPCC recommends that the TNPA consistently ensures that its submission is complete and acceptable in all respects prior to the agreed submission date.

NPCC's comments

Following the model used for the 2012-13 financial year, NPA again based its tariff adjustment proposal on the Revenue Requirement Model. This was based on NPA's stated need to recover its investment, its cost of operations, (including maintenance), and to derive a profit from owning, managing, controlling and administering ports and investing in them. It is for this reason that NPA's capital spending plans must be presented to local PCC's for approval in the first instance.

The NPCC questions the use of the Revenue Requirement (RR) Model as the most appropriate method for founding its tariff adjustment application. It appears that not only does it seek to ensure NPA's sustainability and profitability, but also that of the entire business of Transnet. Admittedly this could be seen as speculative, but that is because there is not a high enough level of transparency that would enable assessors to determine the facts with any degree of precision, so that anomalies inherent in the model, are not easy to understand, or resolve. The RR Model presents a natural temptation to NPA to continuously upwardly evaluate its regulated asset base to increase its revenue requirement. It appears that in this process, the main motivation is profit enhancement and we have our doubts whether that takes into account the responsibilities imposed on the Authority in terms of broader benefits to the economy and the need to create an environment that facilitates trade.

3.1.2 Section 73(1)(b)(i) and (c) of the National Ports Act states that the Authority may charge fees in accordance with a tariff determined in terms of Section 72 for provision and maintenance of port infrastructure, port terminals and port facilities, including, amongst others, land rentals and granting concessions and licenses.

It is noted that the tariff applications for 2013/14 submitted by the Authority included its Real Estate business, complying with the decision by the PRSA, in its Record of Decision dated 20 January 2011, not to accept any further applications not including the real business estate.

However, a consolidated real estate value of R1 856 bn has been included in the Application, but not explained in any way.

NPCC's comments

The NPCC disagrees with the Authority's view that the tariff determination for the business should include the Durban International Airport site (DIA) portion. The DIA has not been formally submitted to the NPCC and could therefore not be considered and approved. Consequently, there can be no justification for including it in the Regulatory Asset Base (RAB) underlying the current Application.

3.2 Contents and Completeness

The NPCC gathers from the proposed Tariff methodology and Pricing Strategy Tariff application that the current Real Estate tariff model is premised on typical land valuation approaches without much regard to the nature of the business operated thereon. Furthermore, by virtue of Transnet Port Terminals (TPT) being one of the divisions of Transnet Ltd, assets leased to this organisation by the Authority are not recorded at fair value as these are considered owner occupied in terms of the accounting standards. Hence, in calculating the revenue requirement of the real estate business on this basis and combining the outcome with the balance of the authority's business, the risk exists that cross subsidisation could occur, which cannot be interrogated. While the NPCC accepts that a case can be made for cross-subsidisation in certain areas, as stipulated in the Ports Act, it must be transparent and open to examination. Otherwise it is possible that low productivity and inefficiencies could develop in certain areas of Transnet's business.

NPCC's Recommendations:

The NPCC therefore recommends that the land leased to TPT should be leased at the same rates as it would be to non- Transnet port operators and would like to encourage the Authority in future to be transparent on the total value of rentals acquired. In much the same way as the cargo dues and marine tariffs are published, we feel that the income to be derived from rentals should be similarly exposed.

To date TNPA has not been able to demonstrate true activity based costing with explanations linked to variances. This critical exercise remains outstanding and there for impacts on the completeness of information presented;

3.3 Tariff Methodology

The methodology applied in this tariff application is the revenue requirement approach of determining the opening regulatory asset base and depreciation. The revenue requirement approach takes into consideration the calculation of a revenue requirement in the tariff review year and the conversion of the revenue requirement into a tariff increase, taking into account estimated revenue for the current financial year. The TNPA Application requests multiyear approach in this instance 5 years.

The following formula is used to calculate the revenue requirement

Revenue requirement = (cost of capital x RAB) + operating costs + depreciation + taxation expense – claw back – financing requirements costs of the previous year x (1 + cost of capital previous year) + financing requirements costs current year

NPCC's Comments:

3.3.1 Required Revenue Model

As stated in the 2013/14 Tariff Application it is understood that the Revenue Requirement Model is a widely accepted method of calculation, it appears that there are no restrictions in terms of how NPA justifies a revenue requirement in excess of R10b.

NPCC believes however, that the required revenue model subject to justification may be appropriate, but not if the TNPA real estate business continues to be excluded. So in the absence of any clear indication on TNPA's intentions in this regard, it is difficult to propose a viable alternative. It is extremely difficult to establish what the real RAB is – currently there is no a reliable valuation of assets. And since the RAB is fundamental to the required revenue model, we would suggest that this model is only appropriate once the asset values have been reliably established. Should that not be possible, then one would have to consider an alternative model. In that case we believe the most appropriate model would be one based on the pricing of comparative ports. We understand that the Regulator has embarked on a process of valuation. Once that has been completed and accepted, we would accept that Required Revenue would be an appropriate basis on which tariff increase requests should be calculated, provided the Authority's real estate business is fully and transparently included in its application

3.3.2 Operating Expenses

In the way that the methodology is presented, there are opportunities for anticipated expenditure to be "padded", thereby allowing TNPA to recover expenses that were never incurred. At the same time, it should be possible to establish a mechanism whereby TNPA is encouraged to effect savings through increased efficiencies, and to be appropriately rewarded when such savings are achieved. The existence or otherwise of transfer pricing within the broader Transnet group needs to be interrogated, since it could, if it existed, have a significant impact on required revenue.

NPA is requesting revenue in excess of R10b, with operating expenses of less than R4bn, including what is perceived to be an excessive contribution to Transnet's overheads. Since it appears that dividends are not paid, and tax is a notional figure, the implication is that cash of some R6bn is being generated within Transnet

3.3.3 Regulated Asset Base

In order to establish this with any confidence, it will be necessary to adopt a two-pronged approach. Firstly major assets will have to be correctly and accurately valued, and secondly close examination of the assets themselves will be required. This will ensure that TNPA is held to account in terms of only being permitted to earn returns on assets that are reasonably utilised in the conduct of their business. As things stand at the moment, the NPCC is of the opinion that TNPA's assets have been overvalued in its calculations, though it is not possible for us accurately to quantify the extent of the overvaluation. What we can say is that any overvaluation has a marked effect on the derived revenue requirement.

The TNPA RAB increased from R12b to R60 from 2008 - 2012

3.3.4 WACC

In general terms, the vanilla WACC approach utilized by TNPA is acceptable, and commonly used internationally. However it must be noted that the choice of appropriate numbers for the Beta proxy, the market risk premium and the risk free rate will have significant effects on the ultimate revenue requirement

3.3.5 Capital Investment

One of the difficulties that the NPCC has had in assessing TNPA's applications, has been the lack of documentation supporting its capital expenditure plans, so that has not been possible to express a proper opinion on the appropriateness of the expenditure and whether it qualifies for a return. The question is also raised *whether it is reasonable to expect some groups of port users to pay for investments that may have either been made unwisely or to meet objectives that are not necessarily related to the primary objectives of the business. If for example such investments have been made in furtherance of some political or regional objectives, then we would argue that capital expenditure incurred on those investments should not qualify for any return. The investment in the port of Nqura could be viewed as an example of this.*

3.3.6 Beta

TNPA has consistently used relatively high betas in its applications, and has equally consistently had these reduced by the Regulator in its decisions. We make the assumption that TNPA has based its beta estimates on market indices derived from similar firms. It would appear that these indices have been inappropriately chosen. From the evidence available to us, a more appropriate beta would currently appear to be in the order of 0.7, rather than the numbers in excess of 0.8 as suggested by TNPA.

3.3.7 RISK FREE RATE AND MARKET RISK PREMIUM

It is worth noting that both of these measurements are open to interpretation in a variety of different ways, and are therefore dependent on a degree of subjectivity. Since by definition both of them represent investors' expectations of what they believe is an acceptable rate of return, it is probably appropriate to interrogate whether TNPA is justified in aligning its expectation with that of the market in general.

NPCC Tariff Methodology Recommendations:

The NPCC proposed that the issues discussed throughout the proposed Tariff Methodology first be addressed and reassessed ahead of approving same;

3.4 Pricing Strategy

The issue of Strategic pricing has been discussed in great detail at the Port of Ngqura PCC and also at the NPCC. The principle of differential strategic pricing has been supported in both fora. The Port of Ngqura has been touted as a transhipment hub. TNPA has shown a level of commitment in terms of its differential pricing of transhipment cargoes between Ngqura and Durban from a cargo dues perspective; However Marine tariffs were not taken into account;

As part of its Pricing Strategy exercise, the Authority seeks to re-categorise its business into Real Estate and Marine, but as noted, there is a lack of transparency in the presentation of its real estate activities, which makes it difficult to properly assess the impact of this business on the overall operation.

It is instructive to note that in the current application, the proportion of total revenue to be derived from real estate has increased markedly, with a concomitant decrease in the proportionate contribution from cargo dues. The proportion of revenue to be derived from marine services has increased slightly, but tkhe major shifts are in cargo dues and property rentals.

The logical inference is that tenants will need to increase their charges to cargo sharply. However, it appears that TPT (by far the largest tenant) has undertaken not to increase its tariff by more than the rate of inflation, and this anomaly requires further scrutiny. TPT tariffs were increased by 6% on 1 April 2013, thus (more or less) complying with that undertaking, but in the absence of any clear information on TPT's financial performance, it is impossible to assess its ability to continue to limit tariff increases while continuing to absorb rental increases that would need to be substantially higher than the inflation rate. The possibility therefore exists that port users will in the longer term bear the brunt of increased property rentals. If that is so, then the decreases in containerised cargo dues which have been instituted might become largely irrelevant.

Increase in marine costs does not take cognisance of the fact that the Port of Mossel Bay has "primitive infrastructure" which is restrictive to its operations, in particular fishing vessels and vessels loading liquid bulk as this port specifically caters for the fishing industry and liquid bulk from the oil industry. An increase in marine costs will increase the costs of berthing and port dues but given the rate of depreciation of the old infrastructure such costs to revitalise the infrastructure will be borne by the users and with small scale users trying to enter the industry this will be impossible.

A decrease in marine costs relating to ship repairs will incentivise industry development at the port of Mossel Bay – in line with the industrial development initiatives.

Increase in tug costs should conform with the requirements of the user industries. It should be noted that in a port like Mossel Bay where mainly DP vessels operate, the use of tugs should not be used to gain unnecessary extra revenue to cover up for the planned extra expenditure by TNPA.

Clarity should be sought from TNPA whether the proposed 38% increase in Pilotage costs does not undermine the fact that there are granted exemptions for vessels operating in the oil and gas industry. Clarity should be sought from TNPA on whether the increased Pilotage costs will not lead to the erosion of the consumer surplus considering the fact that there is an after hours cost for requesting tugs and Pilotage at the port of Mossel bay.

With berthing space constraint in Mossel Bay-clarity should be sought from TNPA whether this will advantage TNPA or the users particularly, the Oil and gas industry and fishing industry.

NPCC's Comments:

The NPCC requires a more detailed exposition of how this shift in revenue generation will benefit cargo owners, while at the same time retaining the viability of TPT as a going concern.

Further the NPCC recommends that the issues raised be considered by the TNPA and the Ports Regulator f SA.

3.4.1 MARITIME SERVICES TARIFF

The generalised 4% increase may be misleading because the major liner operators, when confronted with a 5% increase in tugs, and 38.5% in pilots, would find it difficult how this ends up as a 4% increase. This is influenced by a "mere" 2% increase in port dues, but here again, the switch to 6 hour charge periods (not pro rata) makes it difficult to understand how TNPA can accurately calculate this as only a 2% increase. In any event, they suggest that average vessel stay, is currently 119 hours, and that the new scheme **will** become more expensive for stays in excess of 91 hours, so the indication is that for the majority of users, the increase will be more than 2%. Another generalised comment is that GRT may not be the most appropriate unit of measurement for many of the charges, and would another measure, such as LOA or DWT, not be more appropriate? The GRT measurement disadvantages certain types of vessel, notably Pure Car Carriers..

3.4.1.1 Tugs

The proposal states that tug tariffs will increase by 5%. On the positive side, it is noted that discretion as to number of tugs will now reside with the harbour master, but how is it then possible to state that the increase will be 5%? And this creates a suspicion that harbour masters might use the opportunity to allocate more tugs than are actually required, in the interests of generating additional revenue.

Increase in tug costs should conform with the requirements of the user industries. It should be noted that in a port like Mossel Bay where mainly DP vessels operate, the use of tugs should not be used to gain unnecessary extra revenue to cover up for the planned extra expenditure by TNPA.

3.4.1.2 Pilots

It is noted that pilotage is to remain compulsory. There are certain classes of vessel which probably do not require pilots. This was queried after the roadshows, but no account appears to have been given to these representations, and the proposed increase of 38% appears to be unreasonable The principle of differential charges across the range of ports is accepted in view of the very different circumstances at various ports, but Nqura and Port Elizabeth have raised queries as to why their pilotage charges are considerably higher than, for example, East London and Cape Town. We also note TNPA's contention that pilotage charges will be lower than the selected comparator ports, but the selection of the comparator ports is open to question, since the opportunity existed to select comparators that support the proposals.

Clarity should be sought from TNPA on whether the proposed 38% increase in pilotage tariffs does not undermine the fact that there are granted exemptions for vessels operating in the oil and gas industry. Clarity should be sought from TNPA on whether the increased pilotage costs will not lead to the erosion of the consumer surplus considering the fact that there is an after hours cost for requesting tugs and pilotage at the port of Mossel Bay.

With berthing space constraint in Mossel Bay-clarity should be sought from TNPA whether this will advantage TNPA or the users particularly, the Oil and gas industry and fishing industry.

3.4.1.3 Berthing and Running Lines

We accept the principle of consolidating these charges and unifying the charges across all ports, but a 35% increase does not appear reasonable.

It must be noted that while the rationale behind consolidation of berth dues and port dues is welcome at the port of Mossel Bay, this will only benefit high value cargo through lower costs but disadvantaging low value cargo owners who are likely to experience rise in costs.

3.4.1.4 VTS Charges and Light Dues

We understand and accept the motivation given in respect of these items

3.4.1.5 Ship Repairs

It is difficult to understand how the proposed changes will result in a reduction of 10%, though it is possible that this figure will vary substantially between ports. At the same time we accept the motivation to encourage more efficient utilisation of drydocks, while making the pricing of facilities more attractive to potential users.

3.4.1.6 Employment of Seamen and discount structures

The NPCC believes that the current volume discount offered to liner operators should be maintained to encourage major operators to maintain and increase their calling frequency. We applaud the possible design of a structure to encourage employment of South African seamen, but we cannot see why this should preclude the offering of a discount structure to volume users, in line with normal commercial practice.

3.4.1.7 Transhipment Vessels

The NPCC believes that a case can be made for offering a preferential marine services tariff structure to vessels calling for purposes of transhipment at the port of Nqura. This would fall in line with the TPT policy of doing the same thing, and it would also assist in directing transhipment traffic to Nqura. Members will be able to assist in terms of showing TNPA the relevant statistics. It is further noted that the existing low cargo dues for transhipment are of assistance, but they are not particularly significant in influencing a carrier’s decision to use a particular port, whereas a discount in marine charges would certainly make a difference

It is reported that 62% of all container volumes routed through Ngqura are transhipments and in order to sustain these volumes and continue to market this port as a transhipment hub port servicing sub Sahara Africa,we need to incentivise NCT by offering reduced tariffs. A very good example of the potential downside can be seen in Cape Town, whose year-to-date container volumes have declined this year, largely due to the loss of transhipment cargo.

Whilst we all agree that port efficiencies are critical in attracting additional volumes, the operational costs incurred by the shipping Lines are as important when looking at directing additional volumes through an appointed hub port. Therefore pricing of services needs to be competitive with that of competing hubs in order to maintain existing business and to acquire additional transhipments presently done outside South Arican ports.

It was calculated that the additional costs incurred by a shipping line to tranship containers that were normally handled at Durban to now tranship same containers at Ngqura:

A typical feeder vessel consumes 135 tons of fuel on average per day.

Transit Time Durban/Ngqura/Durban = 2 days.

2 days x 135 tons x USD 700/ton = USD 189000.00

ROE 8.5 = SAR 1606500.00

This is just the price for bunkers incurred extra per vessel and excludes the additional port call expenses.

With this type of pricing whilst it is important to reduce the transhipment cargo dues for full and empty containers this amount would be of little significance to the Shipping Line therefore we propose a substantial reduction in Marine Costs to offset/subsidize these additional costs.

TNPA states clearly in its own presentations that to make transhipments attractive, the economic and operational benefits must outweigh added economic and operational costs.

3.4.2 Cargo Dues

In general terms, the moves to rationalise the system are welcomed, but we will be commenting on specific items within that. Similarly, the move to reduce overall cargo dues revenue by 25%, and container cargo dues by an overall average of 55% is to be applauded. But it raises the question of how the "lost" revenue will be recovered. Obviously we accept that property rentals and to a lesser extent, marine charges will assist in this, but it is also clear that cargo dues on bulk and break-bulk cargoes will have to be increased significantly. There are doubts about whether this is either desirable or sustainable. Another question that has been raised within the NPCC is whether or not there may be a “hidden agenda” in terms of which TNPA might be artificially influencing a swing to containerisation with the purpose of justifying investment in new port developments. There are also suspicions that radically increased rentals will result in increased charges to port users, thus rendering them ultimately no better off.

3.4.2.1 Break Bulk and Bulk Cargo

There are particular categories of break-bulk and bulk cargo which will be seriously affected by the proposals. While the Regulator’s comparative study indicates that South African ports are relatively cheap in the international context, we believe that some of the proposals have a serious negative impact on certain South African industries. The specialised exports of citrus to the USA and Japan, which cannot be carried in containers, are a case in point, and these can ill afford an increase of 65%. Bulk cargoes in the metals and mining industries would be similarly affected, and given that TNPA is bound to promote export traffic, we question whether these large increases can be justified.

NPCC’s recommendations:

- **The NPCC recommends that strategic regional tariffing be considered in Ngqura as a means of consolidating and attracting transhipment business there;**
- **The NPCC recommends that the economic implications of radically increased cargo dues on Bulk and Break bulk cargo be revisited so that the impact on trade can be properly assessed.**

- **The NPCC recommends that TNPA be instructed to produce detailed information showing how its proposed increases in property rentals might impact on cargo owners.**

3.5 Content specifics

3.5.1. NPA's Regulated Asset Base

The NPCC observed that over a three year period the NPA moved from a RAB of R12bn to R48bn without adding any significant additional assets.

This was primarily through a revaluation of existing assets, which has resulted in the figure of R66 315bn for 2013/14. This revaluation has been carried out during a period when real estate values have been negatively impacted by the global financial crisis. The NPCC maintains its line of questioning as to the justification for TNPA increasing its RAB as dramatically as this, since it inevitably results in tariff increases that have a negative impact on the SA economy! This unprecedented artificial increase in the NPA's RAB presents a serious concern as it has a major impact on the tariff calculations. While this approach may benefit Transnet and its shareholder, it has a direct impact on the cost of doing business in SA.

NPCC's Recommendations:

It is recommended that a more realistic valuation of historic assets be used in calculating NPA's RAB when preparing future tariff applications.

4. RECOMMENDATIONS

It is recommended that the PRSA:

i. Does not approve the proposed multiyear tariff Methodology and Pricing strategy until such time that the evaluation process has been finalised whereafter the TNPA should re submit their application following the outcome;

ii. Strategic Tariffing be applied across the Port systems i.e. Port of Ngqura be treated in its tariffing application as a transhipment hub.

5.1 NPA to provide full disclosure as to its Revenue Requirements need for R10bn and the application of funds by Transnet.

5.2 Take note of concerns, abnormalities identified and recommendations made by the NPCC throughout this submission in the tariff application by the Authority.

Submitted for the Chairman's consideration.